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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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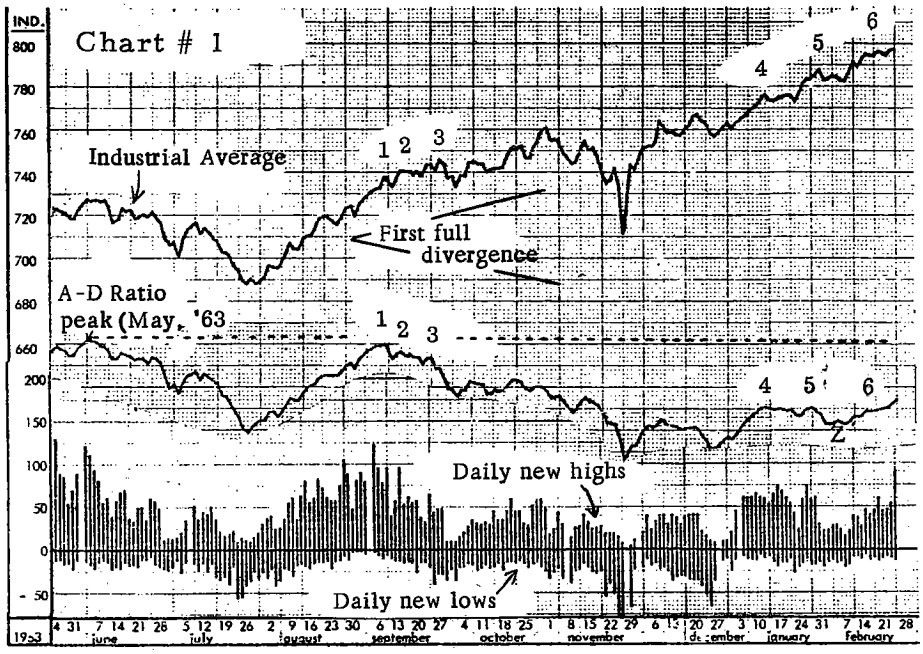
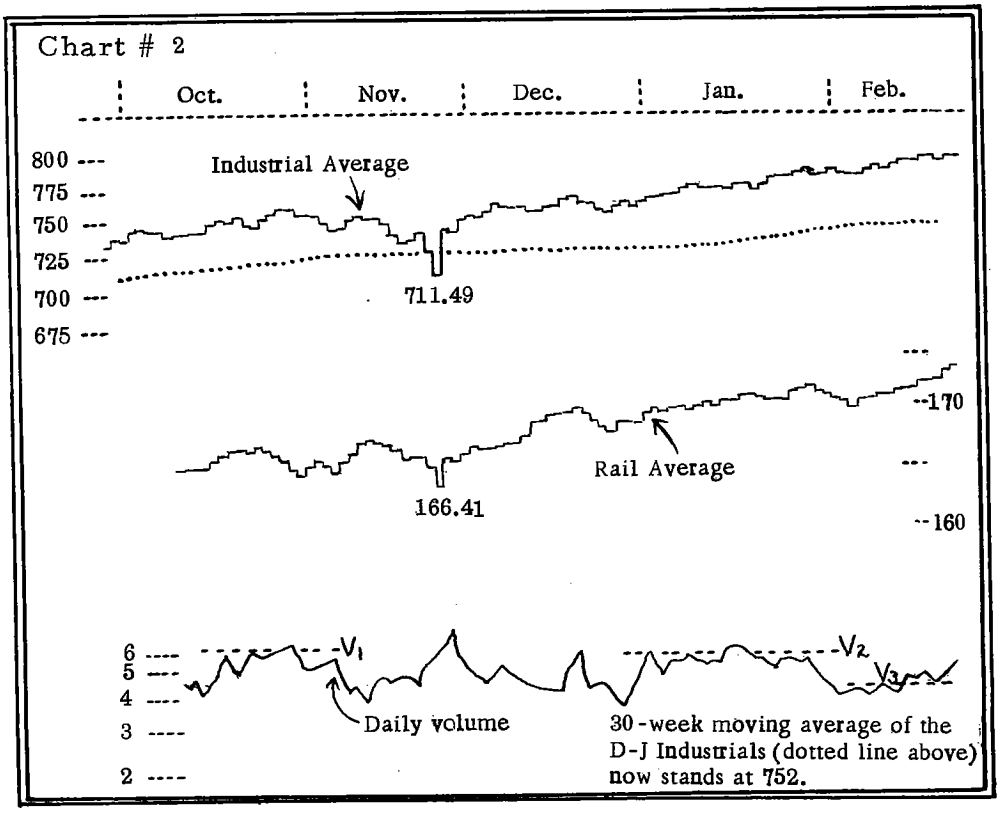
THE MARKET: In the first mailing of this year (Letter 241, January 2) I ventured the following statement: "My bet is that 1964 is going to make up in drama and action for what 1963 lacked." Events so far in 1964 lead me to believe that the bet was a correct one.

Since the "assassination panic lows" of Nov. 22, the D-J Industrial Average has closed during each successive week as follows: 750.52, 760.25, 760.17, 762.08, 762.95, 767.68, 774.33, 775.69, 783.04, 784.34, 791.59, 794.56, 796.99. This means that except for the minor 7¢ loss on the week ending December 13, the Industrial Average has closed at least slightly higher on every one of the thirteen weeks since the President's death. I know of no comparable series in the history of the Averages. From now on, the Industrials will be rising against statistical odds.



Furthermore, it is a remarkable fact that of the thirty D-J Industrial issues, only eight are now at or near their 1963-64 highs. These eight stocks are Telephone, duPont, Kodak, GE, Harvester, Sears, Jersey and Texaco. The Industrial Average itself is presenting a picture of unusual extremes.

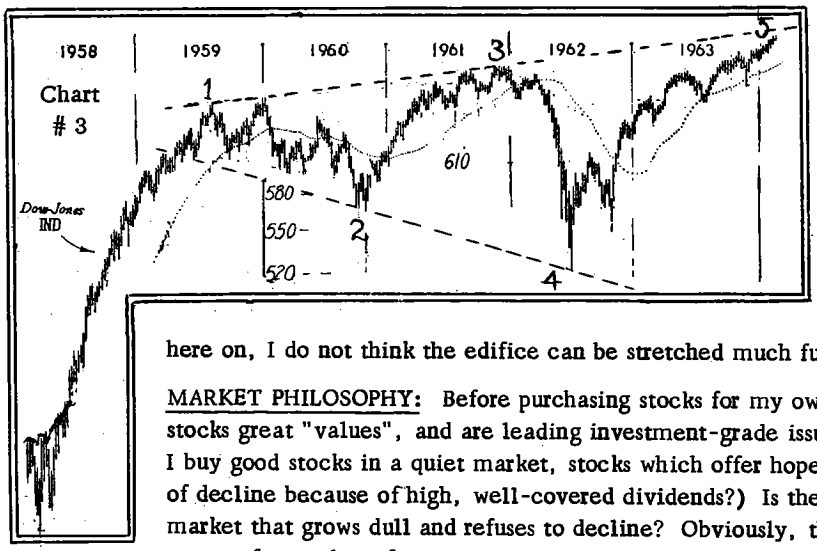
On Thursday (February 20) another extraordinary phenomenon occured. In the last few Letters I have drawn attention to the possibility of a second full divergence between the advance-decline ratio and the Industrial Average. Three declining peaks (4, 5, 6) on the A-D ratio (Chart 1) against three rising peaks in the Industrial Average has always been a dangerous pattern. A closing below point Z on the chart would have completed the breadth-price divergence and would have constituted a major "sell signal". But on February 20 the A-D ratio rose above point 4, thereby reversing or erasing the threat of a second full breadth-price divergence. As far as I know, the action of the A-D ratio in completing three descending peaks (against three rising peaks in the Industrial Average) and then rallying above the first peak is unprecedented.



WHAT NEXT? The Industrial Average is currently in all-time high territory

and approximately at the "roof" of the huge "broadening pattern" (shown on Chart # 3). Although I do not like to bandy the word "unprecedented" about, there is simply no other way to describe this giant five-point reversal pattern, a formation which has been five years in the making. The Rail Average has acted consistently stronger than Industrials and is currently within a few points of its 1929 all-time high of 189.11. The advance-decline ratio (Chart 1) has erased the possibility of a second divergence but is still well under its September 5, 1963, peak and even further below its May 31, 1963, high. Thus, (from the standpoint of the big picture) nine months have elapsed and the A-D ratio is still unable to better its 1963 high. In the light of past market history, the breadth-price relationship remains a dangerous one.

VOLUME In the opinion of the writer, volume could be one of the keys to the market from here on. Note on Chart 2 that the October highs in the Averages were accomplished on daily volume of 6-7 million shares (V_1 on chart), the January highs were recorded on volume of 5-6 million shares (V_2) and the current highs (V_3) have been accompanied by volume of 4-5 million shares. In fact, today (February 24) saw the first over-5-million-share day since January 27, but Industrials after being up over 3 points (and over 800 inter-day) closed up only 13¢. In order to sustain an upward movement, it is absolutely necessary for an advance to attract an increasing following. Such increasing "market interest" is best gauged by expanding upside volume. Watch for rising volume (or the lack of it) during the period directly ahead!



"800 PLUS?" If and when the Industrial Average pushes above the 800 mark, many market students will ask: "Is this the final 'blow-off', the long-awaited speculative explosion corresponding to the final push in 1929?" My answer is that if the Industrials push above 800 (with Rails following) on expanding volume I think that there is a good chance that we will be seeing the final rise, the speculative "tower on top of the skyscraper" which will "top off" the whole post-war market boom. But it will take volume -- and plenty of it! Without increasing volume from here on, I do not think the edifice can be stretched much further.

MARKET PHILOSOPHY: Before purchasing stocks for my own account, I ask myself the following questions. Are stocks great "values", and are leading investment-grade issues now providing historically attractive yields? Can I buy good stocks in a quiet market, stocks which offer hopes of appreciation over the years (with but little risk of decline because of high, well-covered dividends?) Is the prevailing opinion dead bearish in the face of a market that grows dull and refuses to decline? Obviously, these are ideal (or bear market bottom) conditions, and we can forget them for now.

In the absence of the above conditions, I ask myself the next series of questions: is this the bottom of a full correction in what I assume to be a continuing and technically strong bull market? Are stocks (or at least many stocks) still attractive values? Has the bull market progressed without showing any signs of a third phase "top"? Are most stocks in good basing patterns, and do they show signs of having been under strong accumulation? These conditions describe markets such as late 1953-early 1954 or late 1957-early 1958. They simply do not exist now, so we must therefore try a third series of criteria.

Is the advance still "strong" from the technical standpoint? Are the two Averages, Industrials and Rails, rising to successive confirmed highs? Is volume tending to rise with higher prices? Are the majority of stocks (as measured by the Advance-Decline ratio) confirming the rise by taking the A-D ratio to fresh new highs? Are daily new highs tending to expand as the Averages push higher? Do stocks rise, hold their gains relatively well, then push out again to new highs? Is there general skepticism regarding the rise, and are the odd-lotters selling in the face of the advance? Is the short interest ratio (a gauge of relative skepticism) holding above 1.5 and preferably above 1.75? Is the rise tending to "spread out" among the laggard and secondary issues or is it confined to a handful of strong stocks and a few strong groups? If these questions add up on the positive side, I am willing to call it a "good speculative market" and I am willing to commit a portion of my funds.

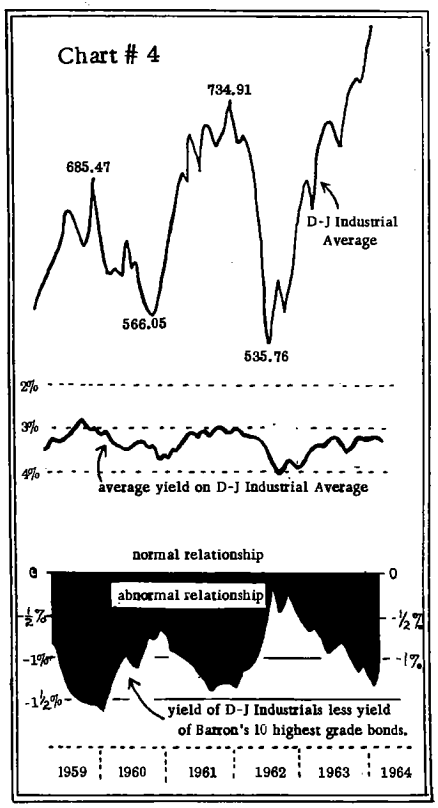
What of the current market? How can we classify it in regard to these various criteria? (1) The Averages are rising to joint new highs, but volume has been unimpressive. (2) The advance-decline ratio recorded a high on May 31, 1963, and after nine months it has still failed to better that early peak. A major breadth-price divergence occurred in September, 1963, but the threat of a second divergence was recently erased. (3) Daily new highs are not impressive, and new highs have actually been lagging badly since their April, 1963 peak. (4) Most stocks show an inability to "move out" with the Averages; those that do seem unable to hold their gains. Typical action is a rally, high volume "churning", and then a decline to earlier levels. (5) The odd-lotters have changed from a heavy rate of selling to about equal buying and selling — in the face of a rising market. This is neutral action. (6) General opinion is bullish to mixed, regarding the future course of the market. (7) The short interest and short interest ratio must now be rated bullish-neutral.

Personally, I feel this way: money is hard to accumulate after taxes. The stock market is going to be here for a long time. There will be long-term buying opportunities in the years ahead, and there will probably be excellent intermediate-term buying opportunities in the months ahead. I do not believe that this market warrants my money at present, and I am fully aware that the

Dow can push up to 1000 ("the market can do anything"). But operating in the market is not a game with me. Cash is a precious tool, and I only use it (1) when stocks are statistically "cheap", and when it is absurd in the light of history to hold cash when I should be holding equities, or (2) when the criteria which I have outlined above suggest that the odds are heavily in favor of a generally rising market (even though stocks may not be great values). In other words, I want real investment values or I want real odds.

As long as subscribers understand all this, they will also understand my approach and my caution. Those subscribers who insist on "action" can get plenty of it (they need only turn to page 4 of these Letters — where stocks for action are mentioned with every mailing). But subscribers should remember that I will treat them like professionals. And professionals want the odds on their side (ask yourself what sort of odds you want in your own business).

VALUES: Letter 241 contained a chart showing the yield differential between the D-J Industrials and Barron's 10 Highest-Grade Bonds. A number of subscribers have written to ask for more on the yield relationship. Chart # 4 presents five years of this history, and I have added the actual D-J Industrial yield (monthly). The chart is particularly interesting since it covers the period of the two preceding major market tops (the tops of 1959-60 and 1960-61).



Historically, common stocks have been priced to yield more than fixed debt instruments or bonds. On infrequent occasions, common stocks have yielded less than bonds, but these areas have usually coincided with the formation of important market tops. Consciously or unconsciously, "big money" tends to move out of equities when the yield on equities is less attractive than the yield on bonds. The "normal" or historical stock-bond yield relationship is therefore expressed by a positive (or plus) yield differential, a differential in favor of bonds.

This positive yield differential held in effect during most of the 1940's (except for 1945-46) and most of the 1950's. But in late-1958 the yield on the D-J Industrial Average dropped below 4% and also below the yield on Barron's 10 Highest-Grade Bonds. Thus the stock-bond yield spread turned negative, and this is represented by the solid black area on the chart.

Note that the negative spread reached -1.6 in late-1959; at the same time the average Industrial yield dropped to approximately 3%. These extremes in the stock-bond yield relationship and in stock yields proved too much for the market, and a major decline followed. This decline, which carried to the lows of 1960, did not correct the negative yield spread, but despite this a new market advance occurred. Toward late 1961 the Average Industrial yield dropped to 3.2% while the negative stock-bond yield spread widened to -1.5. Important distribution took place in that area, and the resultant collapse took Industrials below their 1960 low.

Nevertheless, at no time during 1962 did the negative-yield-spread reverse, and except for a few weeks in June the average Industrial yield remained in the 3.2 to 3.9% area. In mid-1962 another advance began. The latest advance has again pushed the yield relationship to extremes. As of this writing, the average yield on the D-J Industrials stands at 3.3% while the negative stock-bond yield differential is approximately -1.06. Thus average Industrial yields are back in the adverse 3 to 3.5% area, and the negative stock-bond yield has returned to the very negative -1. to -2.% zone. Under these conditions it is absurd to talk about "investing" in equities, and it should be understood that the historical yield and stock-bond yield relationships now put equities in the upper range of what must be considered a dangerous area of overvaluation.

SUNDRY COMMENTS: Many astute observers are of the opinion that the U.S. world position is going from bad to worse. It is obvious that the Administration has been ready to do anything to "keep the lid on" the gathering series of foreign altercations which have cropped up from Viet Nam to Cuba to Panama. Sensing the lack of direction in this country, de Gaulle is unquestionably now making his bid for leadership of the free world.

To add to the drama of the situation, it should be remembered that foreign governments have come to understand that a U.S. election year (when the nation is preoccupied with politics and the President is preoccupied with keeping everything "peaceful") is a good time to "steal the candy". Perhaps it was no coincidence that the Suez crisis (1956) and Castro's takeover in Cuba (1960) both occurred during presidential election years. Thus the "peaceful year 1964" (see "Contrary Opinion" in last Letter) could also end up as a big surprise.

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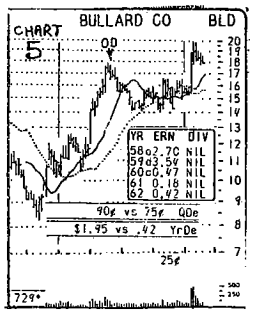
The following is from a letter sent to me on February 16. The writer is a veteran market student who has been observing and writing about Wall Street since the 1930's: "My thought at the moment is that caution may be too widespread. The Philadelphia Inquirer headlines today, 'Averages squeek out new high, but many stocks lag behind.' (This is a paper which has a normal bias toward bullishness). Don't misunderstand me. I am aware of the dangerous situation in the A-D ratio, as well as prevailing lack of real bullish assurance to be found in other indicators, and yet I suspect that this market may be able to keep going for a while, until things get <u>really</u> rotten."

And this interesting comment from a veteran West Coast observer (February 20). "Few years ago we made up the 'Pink Cloud' phrase for the type of company whose 3 year earnings were running in geometric progression - 10¢ - 20¢ - 40¢, etc. As the years went on, there were sort of 'fads' in this type of thing. American Photocopy was 46 - now 10. Automatic Canteen 52 - now 14. Brunswick 74 - now 12. Fairchild 100 to 34, Random House 37 to 9. Raytheon 67 to 18. Texas Instruments 205 to 62. Varian 77 to 14. If you can remember back, these things sort of went in cycles or 'fads'. Sometimes, though it's rare, a high-grade issue temporarily has sort of a set-back. From late '61 to mid '62, even the sacred IBM declines from 600 to 300.

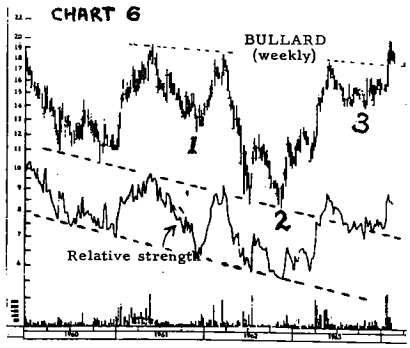
"We're leading up to this: February Fortune's article is called 'The Mysterious Stock Market'. Read it. It's not only the mutual funds that are buying the top-quality stocks. It's the pension funds, foundations, insurance companies. The article points to the <u>constant</u> monthly flow of money - and it simply 'dollar averages' in the top quality stocks. Finish the article - you come to what looks like an <u>unassailable conclusion.</u> Blue-chips can never go down. Eastman Kodak was 20 ten years ago. It's now 125 -33 times earnings, yields 2.1%. It's a wonderful outfit, but we just cannot believe that it is practically guaranteed to advance permanently. The current 'fad' for blue-chip stocks - is it guaranteed to last forever?"

<u>STOCKS</u> Of 432 representative stocks tabulated weekly at this office (see Chart), 262 (61%) are now holding above their 30-week moving averages, no change from last week. The study remains bullish as long as the percentage is above 50%.



The extraordinary diversity of this market is illustrated by two "head-and shoulders" reversal patterns, one a potential "<u>top</u>" and the other a "<u>bottom</u>". Both of these well-known patterns imply great force in the direction of the break-out.

In Letter 239 I recommended Bucyrus-Erie in the very depressed Machinery Group (relative strength of this group has been declining since 1959). Bucyrus subsequently rose from 16 to 26. While there is no guarantee of a similar performance, <u>Bullard</u> in the same group is a picture which intrigues me. BLD sold as high as 50 in 1954, later collapsed to 8 in 1962. It has since formed a huge potential base (inverse head-and-shoulders on chart # 6). Technically, the stock has now completed its reversal, and I do not see much risk in buying it for speculative accounts. Sell it if it breaks below its 30-week moving average (dotted line on Chart # 5). Note that BLD is holding above its short or 10-week moving average (solid line), and the 10-week average is holding above the longer or 30-week moving average (dotted line). Thus, the three indicators are in a bullish relationship to each other.



Last year's "explosion", Control Data, appears to be under distribution, and the stock has formed a beautiful "head-and-shoulder" top. Note the high volume at the left shoulder (1), lower volume at head (2), collapse of volume on right shoulder (3). These volume indications are critical and <u>must appear</u> in head-and-shoulder tops — otherwise the pattern is suspect. Shorting is always difficult, and losses have to be taken when the stock doesn't do what it "ought to". CDA is a short on any rally with (unfortunately) a rather far-away "stop-buy" at 97 (above the February peak or right shoulder).

Charts 1, 6, 7 courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Charts 3 & 5 courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kan.